

TESTIMONY OF
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BEFORE THE

**SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED
ENTERPRISES
OF THE COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES**

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1) Introduction

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to appear before you today. You are examining a subject to which I dedicated significant effort while serving as a Commissioner of the Securities and Exchange Commission.

Well-functioning capital markets are an essential element of our market economy . I remain passionately committed to finding the right answers to the difficult question of how best to provide information to investors, so that our markets will work efficiently and fairly. I appear before you today solely in that capacity. I represent no one but myself.

Our capital markets are the means by which capital flows from those who have it to those who need it. I start with the proposition that no capital markets work better than ours, and ours have never worked better. But recent events have underscored how much better they need to work.

Our capital markets rely on public disclosure to work efficiently. Financial statements, along with other mandated and voluntary disclosures made under our securities laws, are the bedrock of our capital market's disclosure system.

Generally Accepted Accounting Principles are the language of financial statements. More than half a dozen years ago it was apparent that GAAP was beginning to fail, and materially so in important ways, in its essential purpose – to provide useful, timely and relevant disclosure to investors. I have written extensively on these issues and am submitting for the record some of my writings that discuss these ideas in more detail.

2) Today, let me recap five ways in which GAAP falls short, and suggest some reforms

- a) First: What is Measured
 - i) Accounting principles are geared to measure bricks and mortar -- when intangibles like human capital and intellectual property are increasingly important, and in many cases far more important, as drivers of wealth.
 - ii) Accounting principles primarily view intangibles and other drivers of wealth only as measurable if acquired, when for many if not most entities they are generally created internally, not acquired.
- b) Second: Who is Measured
 - i) The boundaries of the firm used to be clearly delineated. You could tell what a firm owned in terms of bricks and mortar and what they did – what they made. Not any more.
 - ii) Off-balance-sheet activities, derivatives, partnerships and various contractual arrangements have blurred the boundaries of the firm.
- c) Third: Timeliness of Measurement
 - i) Things move more quickly now. Even quarterly reporting is deficient; it is too backward looking.
 - ii) More forward-looking disclosure and reporting is needed, but much of that is perceived as anathema to accounting concepts, even though reserves and other items clearly are forward-looking.
- d) Fourth: Access to Information
 - i) Accounting standards require information to be aggregated for presentation according to the language of GAAP.
 - ii) Those who wish to understand what is truly going on have to investigate the information that's presented and undo the aggregation to get the information they need.
 - iii) Moreover, the language of GAAP is now so esoteric and specialized that it is its own. Clearly it is no longer plain English, although it really never was. It is hard to understand by those not trained in its intricacies and nuances, and it now even has its own dialects for different industries, different instruments and different circumstances. Increasingly beyond comprehension for the lay and even many professional investors, we require the issuance of financial statements to all, maintaining the pretense that all should find them useful. At base, we mislead when we suggest that financial statements are being distributed widely because they are widely understandable. They are not. It would be like asking a layperson to read a medical chart, or interpret a foreign language they have never heard before.
- e) Fifth: How it is Measured
 - i) Accounting requirements have become too rules-oriented – they are more concerned about being able to ensure that preparers complied with the rules and less concerned with whether they really make sense.

- ii) Accounting principles need to be principles, not rules. The need for more “goal oriented” regulatory approaches extends, of course, to the SEC and its rules as well.
- 3) The current scandals really highlight how outdated GAAP really is, even as they also highlight illegal behavior. The current scandals would have been mitigated if the issuers had adhered strictly to GAAP, but they likely would not have been avoided entirely because it has been possible to adhere to the letter of GAAP while evading the spirit of fair presentation. There should be no mistaking that one is not the answer to the other – eliminating bad behavior will not make GAAP better, and at base it is in part to blame. We have seen numerous times now where the accounting can be perfectly permissible – but the financial picture presented is as misleading as can be.
- 4) We have also seen perfectly reasonable issuers make the point that current accounting, when followed explicitly and well, still presents a very untrue presentation of a company’s financial position. And we have seen such entities as Standard & Poors and others create their own form of pro forma financial statements to reflect -- more conservatively or more liberally, it doesn’t matter – just differently, a company’s financial position. So what’s a company that’s actually trying to do the right thing do?
- 5) On the other hand – we still remember that our capital markets generally do in fact work well, and they are still the envy of the world. But that success should not lead to arrogance about the future. Times continue to change and now, more obviously than perhaps it was to some a half dozen years ago, we need to do far better by investors.

6) Conclusion

- a) GAAP needs to be revamped to address these issues.
 - i) FASB and SEC have taken some important steps to address intangibles and other key issues.
- b) But rule changes are not the only issue. Rules, no matter how carefully crafted, are continually overtaken by new facts. That’s why we are in the position we are in now with GAAP.
- c) Accounting profession and the companies they audit need to be re-educated about the goals of accounting disclosure – fair presentation of the firm’s finances to investors.
 - i) Technical compliance with GAAP, no matter how much improvement FASB and SEC may be able to make to update the rules should not be a substitute for the ultimate duty of fair presentation.
 - ii) The notion that there can be a rule covering every situation is unrealistic and counterproductive. The notion that every situation can be rolled up into just a few numbers is also, in my opinion, unrealistic and counterproductive. By trying to simplify and having everything be boiled down to just one or a few

numbers we create an impression that those numbers – like net income – can somehow capture all the nuances there are to capture. We need to recognize that matters will get more complex before they get easier – but the solution is more and clearer and better disclosure, not more rules attempting to dictate how everything rolls up to one number.

- iii) This is antithetical to current approaches. Over time, technology will cure the issue: as the entire exercise of taking disaggregated information and aggregating it so that others can then spend their careers attempting to disaggregate it, goes away. Eventually, technology will allow for the distribution of large amounts of data that can then be processed by investors to create their own personalized financial statements. But that day is a long time in the future.
- iv) In the meantime, there are incremental steps to be taken. They range from:
 - (1) providing more disclosure and information as to the primary accounting judgments and issues driving the financial statement presentation, as currently proposed by the SEC and Chairman Pitt;
 - (2) to more in depth disclosures as I proposed a half dozen years ago relating to different levels of information depending on their reliability (“colorized accounting”);
 - (3) to re-educating the profession and the issuers, as well as regulators, as to the need for more “goal-oriented” principles instead of rules-based principles, a task admittedly hard, perhaps even impossible to do in a compelling way, without also addressing the after the fact second guessing that also leads to enforcement actions and securities lawsuits – a topic that most, for good reason, are loathe to reopen or even discuss;
 - (4) , to proposals regarding procedure, such as requiring the equivalent of a concurring partner – but from a different firm – to sign off on the primary and significant accounting judgments and issues noted above and perhaps report independently to a company’s audit committee– a less expensive and perhaps more effective means to assure high quality audits than various other proposed actions that ultimately increase costs in a manner that may outweigh benefits.
 - (5) Other suggestions are described more fully in the papers submitted along with this testimony.

Thank you.